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727164—47

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 778

THOMAS FLEXIBLE COUPLING COMPANY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court's memorandum opinion, entered on May 31, 1944 (R. 61–77),[1] is not officially reported. The opinion of the circuit court of appeals, filed on August 2, 1946 (R. 109–116), is not yet reported.

JURISDICTION

The judgment of the circuit court of appeals was entered on August 20, 1946 (R. 116–117), and a petition for a rehearing (R. 119–126),

[1] All record references are to the Appendix to the petitioner's brief in the court below.

filed on September 4, 1946 (R. 118), was denied on October 10, 1946 (R. 127). The petition for a writ of certiorari was filed on December 10, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The ultimate question is whether so-called royalty payments made by the petitioner were deductible as ordinary and necessary business expenses under Section 23 (a) (1) of the Internal Revenue Code. The precise issue here presented is whether the court below was required to reverse a finding of the Tax Court that an agreement between the petitioner and an inventor for the payment of patent royalties lacked consideration and was therefore not binding on the parties thereto, simply because, in an action instituted by the inventor against the petitioner subsequent to the decision of the Tax Court, a state court had held that there was in fact consideration to support the agreement.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—All the ordinary and necessary expenses paid or incurred during

the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 23.)

STATEMENT

The facts found by the Tax Court may be summarized as follows (R. 62–72):

The petitioner is a Pennsylvania corporation engaged in the manufacture of patented driveshaft couplings (R. 62).

On January 6, 1920, it entered into a contract with one of its stockholders, Mrs. Bertha Thomas, the wife of its principal stockholder and president, for the assignment to it by her of one of the United States patents on coupling devices, which she owned. The petitioner agreed to pay her therefor 450 shares of its capital stock and 10 percent of the total amount of gross sales of couplings for the life of its patent. The peti-

tioner also agreed that she should participate in any future increase of its stock to the extent of 50 percent thereof (R. 62–63).

On March 20, 1920, the petitioner entered into a further agreement with Mrs. Thomas, whereby, in consideration for the assignment of the other two patents on couplings which she owned, and all improvements upon the inventions therein described, as well as for other good and valuable consideration, it granted her a license to manufacture and sell the couplings under the three patents and under all improvements thereon, for automobiles, trucks and tractors (R. 64–65).

The petitioner issued to Mrs. Thomas the 450 shares of stock provided for in the January 6, 1920, agreement, and paid to her the 10 percent of the gross sales price of the couplings it manufactured and sold under the agreement during the life of the patent and thereafter until early 1939, after which a different arrangement was made (R. 65–66).

On September 2, 1937, Mrs. Thomas applied for a patent on an improvement on the couplings, and on August 8, 1939, applied for a patent on another improvement, the first being granted on December 5, 1939, and the second on August 8, 1941 (R. 66). On October 26, 1939, she assigned these two inventions to the petitioner (R. 66–67), and on November 26, 1939, the petitioner entered into an agreement to pay her $3,500 in

cash and 20 percent royalty on all couplings and discs (R. 68–70). The two patents were issued to the petitioner, pursuant to the assignment, on December 5, 1939 (R. 72).

Any license to make or sell under letters patent on the flexible couplings to be used in connection with automobiles, trucks and tractors was without value on October 26, 1939, and November 26, 1939 (R. 72).

The payments made after the execution of the contract of November 26, 1939, were made in accordance with its terms, and the amounts so paid and which are here involved are $4,672 in 1939, $37,151.04 in 1940, and $65,672.10 in 1941 (R. 72).

In its opinion (R. 72–77), the Tax Court concluded that, when the November 26, 1939, agreement was entered into, the petitioner was already the owner of the two improvement patents by virtue of the October 26, 1939, assignment, to which it was entitled by reason of the March 20, 1920, contract; that, being already entitled thereto by the contract, the petitioner was under no legal obligation to make additional payments therefor, and that, consequently, the payments provided for in the contract of November 26, 1939, as voluntary payments made in the absence of an existing obligation, were not "ordinary and necessary expenses paid or incurred * * * in carrying on a trade or business" (R. 74, 76).

The Tax Court accordingly sustained the Commissioner's determination (R. 77), and thereafter denied the petitioner's petition for a rehearing (R. 79–84).

Following the denial of the motion for a rehearing and while its petition for review of the Tax Court's decision was pending in the court below, Mrs. Thomas instituted an action against the petitioner in the Court of Common Pleas of Warren County, Pennsylvania, seeking a declaratory judgment against the petitioner "as to the November 26, 1939 agreement" (R. 112). As stated by the court below in its opinion, the petitioner admitted the facts pleaded by Mrs. Thomas in the state court, including an oral agreement to cancel the 1920 contract, and that court accordingly entered judgment against it upon the "undisputed facts before it" (R. 112–113). The Supreme Court of Pennsylvania affirmed this judgment in an opinion filed March 25, 1946, 355 Pa. 591. A copy of this opinion is printed in the petitioner's brief in support of its petition (pp. 32a–39a). However, Judge Jones, formerly of the United States Circuit Court of Appeals for the Third Circuit, filed a dissent (Br. 39a–43a). The opinion of the Supreme Court of Pennsylvania was filed about twenty days prior to the date of the argument of the case in the court below, which was held on April 15, 1946 (R. 109).

In affirming the Tax Court's decision, the court below rejected the petitioner's contention that it was required to accept the judgment of the Court of Common Pleas, as well as the judgment of affirmance thereof by the Supreme Court of Pennsylvania (R. 109–116).

ARGUMENT

1. The reason the court below rejected the petitioner's contention that it was required to accept the judgment of the Court of Common Pleas, and the judgment of affirmance by the Supreme Court of Pennsylvania, is that, in its view, not only the evidence, but particularly the manner of its presentation, on the controlling issue in the case, was different in the state court than in the Tax Court (R. 113). Thus, as above stated, the court below, in its opinion, said that, in the state court, the petitioner had admitted all the facts pleaded by Mrs. Thomas, including the alleged oral agreement to cancel the 1920 contract, and that the state court had accordingly entered judgment in favor of Mrs. Thomas and against the petitioner upon the "undisputed facts before it" (R. 112–113).

If so, the fact that the Tax Court had reached a different conclusion from the state court as to the respective rights of Mrs. Thomas and the petitioner under the 1939 contract in question did not necessarily involve an application to the facts as found by the Tax Court of erroneous

principles of state law. To the contrary, as the court below said, the Tax Court obviously labored under no misapprehension of law in its decision, but applied to the facts as found by it contract principles which are not only sound Pennsylvania, but universal, law (R. 113).

We submit that, in this view, the decision of the court below is not in conflict with the decisions of this Court in *Blair* v. *Commissioner,* 300 U. S. 5; *Freuler* v. *Helvering,* 291 U. S. 35, and *Sharp* v. *Commissioner,* 303 U. S. 624. Nor is it in conflict with the decisions of the Eighth and Sixth Circuits in the cases of *Eisenmenger* v. *Commissioner,* 145 F. 2d 103, and *Nashville Trust Co.* v. *Commissioner,* 136 F. 2d 148, respectively.[2]

None of these cases holds that a different determination of a fact issue by a state court from that made by the Tax Court, particularly when

[2] The case of *Stoner* v. *New York Life Ins. Co.*, 311 U. S. 464, also cited by the petitioner in this connection (Pet. 6), does not involve the application by a federal court of a federal statute to the facts presented to it, but only the application of state law to facts substantially identical to those before the state court, and is therefore irrelevant here. The case of *Lum* v. *Commissioner*, 147 F. 2d 356, also cited by the petitioner (Pet. 6), was decided by the court below and therefore involves no conflict. Besides, that decision also turns solely upon a question of state law. So far as material here, the question in that case was whether the effect of an assignment of leases of New Jersey real estate was to make the assignee the owner of the "real estate let to lease," within the meaning of the New Jersey statute, the Third Circuit holding that such was the effect and that the state law was controlling with respect thereto.

the evidence and the manner of its presentation are different, vitiates the Tax Court's determination and requires the appellate court to substitute the state court's finding for that of the Tax Court. Cf. *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231, as also *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, upon which the court below relied.

The situation here is to be sharply distinguished from the cases cited by petitioner. Here the issue was whether, and to what extent, the dealings between Mrs. Thomas and the petitioner, from 1920 to 1939, had crystalized their contractual rights as of the date of the November 29, 1939, agreement. Upon that, and upon that alone, depended the validity of that agreement. Thus, until it was established that the 1939 agreement was controlling between the parties, the Tax Court had no occasion, and was not required, to determine the legal consequences which flowed therefrom under state law, in order, in turn, to apply the federal taxing statutes thereto.

In each of the cited cases, however, the Board of Tax Appeals, or the Tax Court, had merely applied erroneous principles of state law to the admittedly determinative instrument before it. Thus, the *Blair* and *Freuler* cases, as well as the *Eisenmenger* case, involved state court determinations of the legal effect of certain trust

instruments, with regard to which the Board of Tax Appeals and the appellate federal courts had reached different conclusions. In the *Sharp* case the taxpayer argued, and the Commissioner assumed, that a similar question was presented, and this Court apparently made the same assumption, since it disposed of the case by a memorandum opinion, in which it cited only the *Blair* and *Freuler* cases.

As regards the *Nashville Trust Co.* case, we repeat what was said in the Government's Memorandum (p. 10, footnote 4) in the case of *Sewell* v. *Commissioner,* No. 754, October Term, 1945, certiorari denied, 327 U. S. 783, to the effect that while we differed with the view of the circuit court of appeals that the question whether the claims there were contracted for an adequate consideration in money or money's worth was controlled by state law, it was nevertheless true that the Sixth Circuit Court of Appeals had considered the question to have been referable thereto.

That the state court's judgment is not controlling in the federal tax litigation under the decided cases is further evidenced by the fact that that judgment was based on a submission of the issue to the state court in a proceeding which was in fact non-controversial, the parties thereto seeking a decision only for the purpose of affecting the Government's right to tax (see Peti-

tioner's Br. 32a). We think that this Court's discussion in *Freuler* v. *Helvering*, 291 U. S. 35, 45, applies here to condemn such action.

2. Whether, as the court below held, the Pennsylvania Supreme Court decided the case before it as it did because different facts were presented to it from those before the Tax Court, or whether the state court's ruling had a more direct relationship to the case before the Tax Court, is hardly a question of general importance warranting review by this Court. In *Sewell* v. *Commissioner*, No. 754, October Term, 1945, certiorari denied, 327 U. S. 783, the Government did not oppose certiorari, because it was felt that the effect of state court judgments on issues of fact in federal tax proceedings was a problem which could bear clarification. But in this case, the basis for the state court's judgment is, at best, unclear. Moreover, the petitioner does not contend that a circuit court of appeals is bound by a state court's determination of a fact issue contrary to that made by the Tax Court. Hence this seems to be a particularly inappropriate case to serve as a basis for clarification, and thus, there is even less reason for granting review here than there was in the *Sewell* case.

3. Petitioner makes one additional contention in support of review by this Court. It urges that if it was not entitled to the deduction claimed under the 1939 contract, because there was no

consideration to support the agreement, it would nevertheless be entitled to the deduction under the 1920 contract, because that contract would, in such event, have still been in force and effect (Br. 13–16). But no such contention was presented to the Tax Court or properly raised in the court below. The court below did not pass upon it and the Tax Court made no findings on the basis of which this question could have been determined.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

GEORGE T. WASHINGTON,
Acting Solicitor General.
SEWALL KEY,
Acting Assistant Attorney General.
STANLEY M. SILVERBERG,
HELEN CARLOSS,
CARLTON FOX,
Special Assistants to the Attorney General.

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